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Decision 03-02-073 February 27, 2003

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking on the Commission's Own Motion to Assess and Review The New Regulatory Framework for Pacific Bell And Verizon California Incorporated.	Rulemaking 01-09-001 (Filed September 6, 2001)
Order Instituting Investigation on the Commission's Own Motion to Assess and Revise The New Regulatory Framework for Pacific Bell And Verizon California Incorporated.	Investigation 01-09-002 (Filed September 6, 2001)

ORDER DENYING REHEARING OF DECISION NO. 02-10-020

I. SUMMARY

By this decision we deny the application for rehearing of Decision No. (D.) 02-10-020 submitted by Verizon California Incorporated (Verizon). D.02-10-020 is an interim opinion (issued in Phase I of Order Instituting Rulemaking No. (OIR) 01-09-001 and Order Instituting Investigation No. (OII) 01-09-002) in our triennial review of the New Regulatory Framework (NRF). (This proceeding represents the fourth triennial review of NRF.)

The first phase of the proceeding considered factual issues arising from the Office of Ratepayer Advocates' (ORA) audit of Verizon generally covering the years 1996-1998. ORA's audit was conducted pursuant to Public Utilities Code section 314.5 and Commission Decisions 98-10-026, 98-10-019, 96-05-036, and 94-06-011.

ORA submitted its audit report to the Commission. In the report, ORA alleges that Verizon repeatedly failed to comply with various Commission rules and regulations, resulting in Verizon accruing more than $100 million in higher costs and lower revenues. Most of the issues raised in the audit report were settled by agreement between ORA, The Utility Reform Network (TURN), and Verizon. ORA, TURN and Verizon submitted a Joint Exhibit (concerning and resolving most of the issues identified in the ORA's audit report to the Commission), that the Commission treated like a stipulation and adopted by the interim decision.

One unresolved issue concerned Verizon's relationship with its affiliate, Verizon Information Services (VIS) responsible for publishing White Page and Yellow Page directories, i.e., "the directory affiliate." During the audit period, Verizon and its directory affiliate shared revenues obtained from publishing White and Yellow Page directories. (D.02-10-020 at 16.) Verizon received 63% of the revenues, which amounted to approximately $147 million to $153 million annually during the audit period. ORA alleges that the directory affiliate reaped excessive earnings from its share of the directory revenues and recommends that the excessive earnings be imputed for ratemaking purposes. (*Id.*) ORA and Verizon agreed to define excessive earnings as all of the directory affiliate's earnings from its directory operations in California that exceeded a rate of return (ROR) of 11.5%. The amount of the alleged excessive earnings in 1996 was $20.5 million, $6.2 million in 1997, and $35.6 million in 1998, or a total or $62.3 million during the three audit years. TURN supported ORA's proposal to impute excessive directory earnings for ratemaking purposes and Verizon opposed the proposal and by its application for rehearing continues to oppose the concept.

By the interim decision we required Verizon to file revised financial monitoring reports for every year beginning with 1996 that reflect all of the directory affiliate's excessive earnings from the publication of White and Yellow Page directories as set forth in a table on page 29 of D.02-10-020. Verizon is further required to continue to file financial monitoring reports that reflect all directory earnings in excess of 11.5% until further notice. (Phase 3 of this proceeding will address the regulatory treatment of Yellow Page revenues; Phase 3 will also consider whether the Commission should determine the existence and amount of excessive directory earnings in the future using a ROR of 10.5%, 11.5% or some other ROR.) (D.02-10-020 at 28-29.)

We have carefully considered Verizon's contentions and are of the opinion that good cause for rehearing has not been demonstrated. Accordingly, we deny the application for rehearing.

II. DISCUSSION

Essentially, Verizon does not agree with our regulatory treatment of the excess earnings of its directory affiliate. Verizon contends that the interim opinion is fundamentally flawed in determining that the earnings of its directory publishing affiliate in excess of 11.5% must be included in the utility's earnings for purposes of sharing with its ratepayers under the NRF. Verizon argues that we have failed to consider various Commission decisions regarding directory earnings, ignored previously established facts and Federal Communications Commission (FCC) accounting rules adopted by the Commission, and that the decision "perpetuates the outmoded notion" of an authorized rate of return for the directory affiliate. Verizon raised these issues during the hearing and we considered and rejected them for the reasons set forth in the challenged decision.

The heart of Verizon's complaint is the interim opinion's conclusion that its directory affiliate is a regulated subsidiary. Verizon contends that VIS is an affiliate rather than a subsidiary and therefore not a regulated entity that Verizon is required to report transactions with to the Commission. This issue is thoroughly discussed in the interim opinion, which provides historical context to Verizon's argument, noting that "[d]irectories were developed at ratepayer expense and, in return, the earnings from directories were used to offset the cost of providing local telephone service…." (D.02-10-020 at 21.) Indeed, although Verizon has conducted its directory operations through an affiliate since 1936, "[t]he lack of an arms-length relationship between Verizon and its Directory Affiliate has been a long-standing source of concern to the Commission." (*Id*.)

D.02-10-020 discusses the history of ratemaking treatment regarding Verizon's directory affiliate, particularly focusing on the distinction made during the proceeding and now by Verizon between a subsidiary and an affiliate, and references a 1969 Commission decision stating:

> It is immaterial that the [Directory Affiliate] has been formed as a corporation separate … from [Verizon]… Nothing magical happens in relation to function when corporate papers are filed with the Secretary of State; it is the work and function that an entity performs that determines its regulatory treatment, rather than what lawyers put in incorporation papers. (*Id*., at 22, citing D.75873.)

That 1969 decision concluded that Verizon (then General Telephone Corporation) and its directory affiliate "do not bargain at arms length over the division of directory revenues … [and that] [t]he Directory Company is used … to siphon profits from [Verizon]." (D.02-10-020 at 22, citing D.75873.) Consequently, the Commission then decided that in order to prevent the affiliate from making an unreasonable and excessive profit on its business with Verizon, it would reduce Verizon's expenses by an amount for the test year. (*Id*.) The Commission made similar findings in each of Verizon's subsequent general rate cases (GRCs) (up through the last GRC for Verizon prior to NRF), so that in the decades prior to NRF, the Commission imputed for ratemaking purposes all of the directory affiliate's earnings from its operations in California that exceeded Verizon's Commission-authorized ROR. (*Id.*) "The effect of this practice was to reduce Verizon's rates by the full amount of the Directory Affiliate's excessive earnings." (*Id*.)

In addition, as noted in D.02-10-020, "[t]he Commission has consistently interpreted [Public Utilities Code] § 728.2(a) as allowing, if not requiring, the Commission to use directory earnings to offset the cost of providing basic telephone service." (*Id*., at 23.) In 1989, by D.89-10-031, the Commission distinguished directory earnings from ratemaking adjustments so that Verizon kept all of its earnings up to an ROR of 13%; thereafter it shared all earnings between 13% and 16.5% with its ratepayers. D.89-10-031 required Verizon to return all earnings over 16.5% to its ratepayers. (D.02-10-020, at 24.) However, by D.91-07-056, the Commission excluded from sharable earnings the "ratemaking adjustment" for directory earnings. (*Id*., at 25.) D.02-10-020 specifies that the earnings themselves were not excluded. (*Id*.)

> By excluding this ratemaking adjustment from sharable earnings, the effect of D.91-07-056 was to no longer allocate 100% of excessive directory earnings to ratepayers, but to include excessive directory earnings in the determination of sharable earnings in the same manner as Verizon's other costs and revenues. Thus, ratepayers were to share in the Directory Affiliate's excessive earnings to the extent these earnings, when combined with Verizon's earnings from its regulated telephone operations, exceeded the threshold for sharable earnings. The Commission's treatment of directory earnings in D.91-07-056 was consistent with the Commission's determination in D.89-10-031 that directory earnings, but not ratemaking adjustments, should be included in sharable earnings.[] (*Id*., at 25-26.)

D.02-10-020 states that generally the Commission has treated directory affiliates as if they were part of the regulated utility and thus did not apply its affiliate transaction rules to such affiliates and require utilities to report significant transactions with such affiliates. Rather, directory affiliates have generally been treated as regulated subsidiaries, as defined in D.93-02-019. (D.02-10-020 at 26-27.) D.02-10-020 concludes: "<u>Although Verizon's Directory Affiliate is a sister company, not a subsidiary, the Directory Affiliate nonetheless satisfies the definition of 'regulated subsidiary' because its net revenues[] are imputed for ratemaking purposes</u>." (*Id*., at 27, emphasis added.)

Verizon takes issue with this, arguing that its net revenues are not and never have been imputed for ratemaking purposes—only its excess earnings. However, D.02-10-020 specifically provides in footnote number 41 that the term "net revenues" used in D.93-02-019 incorporated all earnings, including "excess directory earnings." (D.02-10-020 at 27.) Accordingly, we concluded that in-line with its regulatory history and policy, the excess earnings of Verizon's directory affiliate should to some extent be reflected in the earnings-sharing mechanism.

Although Verizon continues to disagree with us regarding the designation of its directory affiliate, for all of the reasons set forth in D.02-10-020, for purposes of regulatory treatment of Verizon's directory affiliate, we shall, as we have in the past, continue to treat it as a regulated subsidiary. Verizon fails to establish that we have committed legal error by not departing from our "long-standing Commission practice [of] requir[ing] excessive directory earnings to receive the same ratemaking treatment under NRF as Verizon's other revenues and expenses." (*Id.*) Verizon's argument on this issue is without merit.

Verizon also contends that the ratemaking treatment at issue for excess directory affiliate earnings violates FCC accounting rules adopted by the Commission. The FCC accounting rules Verizon relies upon provide in part that the "revenues associated with the publication of yellow pages directories by an affiliate may not be recorded on the carrier's books." That same accounting rule is referenced by D.02-10-020 in Conclusion of Law No. 17 and we are in agreement with Verizon on its requirement. (Phase 3 of the proceeding will address the regulatory treatment of yellow pages revenues; see D.02-10-020 at 28, fn. 44.) For ratemaking purposes the Commission imputes revenues related to the affiliate's publishing of directories. (See *id.*, Finding of Fact Nos. 19-21.)

D.02-10-010 provides:

> We agree with ORA and TURN that the imputation of directory earnings is consistent with FCC regulations. The FCC's own rules allow states to impute directory revenues for state ratemaking purposes. Further, the

> Commission in D.91-07-056 held that the determination of sharable earnings starts with the FCC's Part 32 accounts, less Part 36 (separations) and Part 64 (below-the-line cost allocations), plus or minus any modifications adopted by this Commission.[] Directory earnings have always been included as one of these modifications. (*Id*., at 29-30.)

Verizon argues that it "never included VIS's excess earnings on its regulated books or on its NRF earnings reports, but did include revenues received under its publishing contract." (Verizon application for rehearing at 17, emphasis omitted.) Yet, D.02-10-020 does not require Verizon to record revenues associated with yellow pages directory publication on its books. Verizon's argument on this point is without merit.

Verizon next contends that the outcome for Roseville Telephone Company in its NRF audit conflicts with the result of the interim opinion. Contending that the Commission did not order Roseville's directory affiliate's excess earnings over an authorized rate of return to be included in the sharing calculation, Verizon admits that Roseville "is not explicitly subject to the provisions of D.91-07-056…." However, Verizon opines that since Roseville is under the NRF, "[n]o basis for a different result than one reached for Verizon or Pacific Bell] exists … and therefore fairness and sound policy dictate the same result for Verizon." (Verizon application at 19.)

Obviously, Verizon and Roseville Telephone Company are different entities and Roseville was not part of this proceeding. Verizon readily admits that Roseville is not subject to the provisions of D.91-07-056, which in part adopted the Commission's then Advisory and Compliance Division's recommendation regarding the traditional ratemaking adjustment for excessive directory earnings referenced above and discussed in D.02-10-020 at pages 25-27. As discussed in the challenged decision, "the effect of D.91-07-056 was to no longer allocate 100% of excessive directory earnings to ratepayers, but to include excessive directory earnings in the determination of sharable earnings in the same manner as

Verizon's other costs and revenues." (D.02-10-020 at 25-26.) Verizon has not established that we has acted unreasonably and committed legal error in treating it differently than Roseville Telephone Company and the allegation is without merit.

Finally, Verizon takes issue with the policy of requiring excess earnings of a directory affiliate to be included in sharing because it "contradicts the essence of NRF." (Verizon application for rehearing at 18.) However, the argument presented by Verizon is entirely a policy argument and appears to be similar to that which it pursued during the hearing. Applications for rehearing of Commission decisions specifically provide an opportunity to present the Commission with allegations of legal error within a challenged decision, not with policy arguments. The issue is without legal merit.

III. CONCLUSION

Verizon has demonstrated no legal or factual error in D.02-10-020, which is supported by substantial evidence, and rehearing should be denied.

Therefore, **IT IS ORDERED** that:

Rehearing of Decision No. 02-10-020 is denied.

This Order is effective today.

Dated February 27, 2003 at San Francisco, California

MICHAEL R. PEEVEY
President
CARL W. WOOD
LORETTA M. LYNCH
GEOFFREY F. BROWN
SUSAN P. KENNEDY
Commissioners